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"Capital increases when the community produces more than it consumes. Capital decreases when the community consumes more than it produces."

Benjamin M. Anderson, *Economics and the Public Welfare*, Liberty Press, 1949

THE MIRACLE THAT TURNED INTO A MINEFIELD

At the heart of the New Economy was the miracle of new technology. This, according to Federal Reserve Chairman Alan Greenspan and others, was the principal cause of soaring productivity, investment and economic growth. Yet, as we have argued all along, statistical fudging in the form of hedonic pricing of computers and related products was responsible for a large part of reported real GDP growth. And much of the actual growth that did take place happened thanks to a flood of money and credit creation.

The results were soaring stock and property prices, a spike in paper wealth that was destined to be short-lived, and a surge in borrowing and consumption at the expense of savings and capital investment.

For the consumer and most analysts, nothing seemed amiss until the nearly invisible recession of the second half of 2001. Yet the gross imbalances between investment and consumption and saving and credit expansion began to accelerate dramatically in 1998, while profit margins of non-financial corporations went into a sharp decline that has not only continued, but is sure to worsen.

That sharp decline of corporate profits is, in fact, the key to assessing the real state of the U.S. economy — and its prospects for either a recovery or a return to recession.

New technology was certainly the single largest contributor to *reported* economic growth and to the creation of paper wealth during the boom. Yet it was also the worst profit performer all along.

Today, new technology is the single greatest destroyer of wealth and profits in the economy. The plunging value of tech shares will inevitably affect the spending patterns of the seemingly invincible consumer. More immediately, tech malinvestments are already major contributors to hemorrhaging U.S. income statements — as well as to the current state of declining business fixed investment.

Recent, though so far moderate, dollar weakness has induced us to more thoroughly analyze the forces impacting the currency. It is becoming a hot question whether the dollar's decline will be gradual and limited, or whether a steep slide with devastating effects on the U.S. financial markets may be looming. While the consensus expects a strong dollar again next year, we see it falling over time to new all-time lows against the major currencies.

Taken together, the extreme imbalances in the U.S. economy mean that predictions of a speedy recovery are nothing more than wishful thinking. Instead, the United States is likely headed into a deep and protracted recession.

PROFITLESS NEW ECONOMY

Looking back, it is certainly fair to say that the world's leading economic and financial institutions and organizations entered 2001 without the faintest idea of an impending U.S.-led global economic slump. In its *Economic Outlook*, published in December 2000, the Organization for Economic Development and Cooperation predicted real GDP growth of 3.5% for the United States and 3.1% for the euro zone. This was, of

course, the consensus view. Yet, measuring from fourth quarter to fourth quarter, the miserable reality for the year was 0.5% growth in the United States and 0.6% for the euro area.

One would think such flagrant misjudgment would induce some people to bend their intelligence to the question of what has brought America's new paradigm boom of the past several years to such an abrupt halt, even though money and credit have kept expanding at rampant rates. However, such critical reappraisal is hard to find. Instead, there is instant jubilation that America has experienced its mildest recession in the whole postwar period. For many, there never was a recession.

Assessing the U.S. economy's prospects should start with the realization that its downturn last year was diametrically different from past postwar experience in two regards: monetary conditions and the pattern of the downturn.

As to the first point, all postwar recessions had their definite trigger in sharp rate hikes by the Fed that effectively forced both consumers and businesses to curtail their borrowing and spending. Characteristically, money and credit growth used to plunge. The resulting recessions lasted between six and 18 months, with an average of 11. The brunt of the restraint regularly fell on business fixed investment, residential building, consumer durables and especially inventories.

Since monetary tightening was the downturn's immediate cause, monetary easing inherently removed it. Once the Fed loosened its shackles, the economy promptly took off again. What's more, the legacy of the credit restraint was pent-up demand both on the part of consumers and businesses. But it ought to be added that, in previous cycles, credit excesses and corresponding imbalances in the economy were never carried to great extremes.

It cannot be repeated often enough that the causes and pattern of the current U.S. economic downturn are radically different from the garden-variety type of the postwar period. For the first time ever, the economy has sharply slowed in the absence of any monetary tightening. Money and credit expansion never showed the slightest letup.

Although the Fed cut its interest rate by a total of 475 basis points during the year, real GDP growth downshifted dramatically from 4.1% in 2000 to a virtual standstill in the second half of 2001. During the comparable periods of the past six postwar recessions, such rate cuts have averaged 180 points.

ECONOMIC GROWTH IN THE WRONG PLACES

On the face of it, America's economy seems to be roaring back. Real GDP soared at an annual rate of 5.6% in the first quarter of 2002, leaving the rest of the world far behind. But digging beneath this miraculous headline figure, we discovered a lot of statistical trash.

First, we must always remember that these numbers are annualized. Second, the composition of this rebound makes for very poor reading. GDP in current dollars grew $165 billion, accruing mainly from two sources. The largest contributor was inventories, rising by $79.6 billion. The other major component was another jump in government spending, this time by $51.1 billion. Together, the two components accounted for 79% of reported real GDP growth.

However, there is a big snag in these inventory numbers. The usual story you will read is that economic growth picked up smartly because businesses moved to replenish their depleted inventories. They did nothing of the sort. Instead, they continued to reduce their inventories, but at a slower pace than in the previous quarter. In GDP arithmetic, this is treated as a diminished subtraction that adds to GDP growth.

Stripping out inventories and government spending, GDP rose $37.1 billion in the first quarter of 2002. The positive contributor was consumer spending on nondurable goods and services; the drags came from consumer spending on durables, business capital investment and net exports. This is definitely not the pattern of demand with which cyclical recoveries usually start.

In other words, the great furor that has been made of the stellar GDP growth rate of the first quarter is grossly misplaced. It only served to divert attention from the U.S. economy's key problem: the most miserable profit performance since the 1930s.

INVESTMENT BUST

A striking feature of the economy's downturn was its most unusual pattern. From the first quarter of 2000 to first quarter of 2001, real GDP rose $147.6 billion. The distinguishing features were diametrically opposite movements of consumption and investment. While gaining $209 billion from higher consumer spending and $92 billion from higher government spending, real GDP lost $153 billion from the corporate investment bust and another $40 billion from a higher trade deficit.

This abnormal downturn pattern has effectively no precedent in postwar business-cycle experience. Essentially, we have to assume that it has not evolved just by accident, but that it reflects specific, abnormal causes. Since an economic recovery implies that the causes of the prior downturn have been removed, it appears indispensable to identify these causes in the first place.

While in general the profit malaise has been recognized, there still remains a general, flat denial as to its underlying nature and its crucial role in bringing on the worst investment crisis in the postwar period. The first gains in real GDP growth, reflecting mainly the inventory cycle, were immediately seized upon as unquestionable proof of a beginning recovery. For sure, this used to be the normal cyclical pattern. But to repeat: this time, everything is radically different.

The obvious immediate cause of the U.S. economy's downturn has been a conspicuous bust in business fixed investment, whose root cause is meanwhile well documented. Profit margins always shrink during recessions. This time, though, the profit decline is outright carnage. Corporate profit margins are at their lowest at any time since the Depression of the 1930s.

NONFINANCIAL PROFITS PEAKED FIVE YEARS AGO

Yet there is something that matters even more than the steep slump of profits during last year's slowdown. That is the fact that the profits malaise, measured in the more reliable framework of the national income accounts, effectively started well before the recession. Corporate earnings growth began to decelerate in 1997, that is, at the height of the past boom.

Actually, there are two different profit measures: those that the government statisticians calculate and report within the national income-accounts, based chiefly on tax return; and those that the individual companies report and which go into the profits per share as compounded for the major stock indices. The two profit measures closely tracked each other until 1997. Then, all of a sudden, a huge gap started to open up between them.

Principally focusing on the national-accounts measure of profits, we immediately read the signal. The consensus, focusing exclusively on the profits reported by the firms, failed or refused to see what was happening until last year, when the economy's sharp slowdown strikingly ravaged profits. One of the results is the widespread illusion that the profits implosion derives mainly from the economy's slowdown.

The facts: Pre-tax domestic profits for nonfinancial corporations slumped from $517.5 billion in 1997 to $287.7 billion (annualized) in the fourth quarter of 2001. As a share of nominal GDP, profits fell from 6% to 2.8%. For the postwar period, this decline is unprecedented.

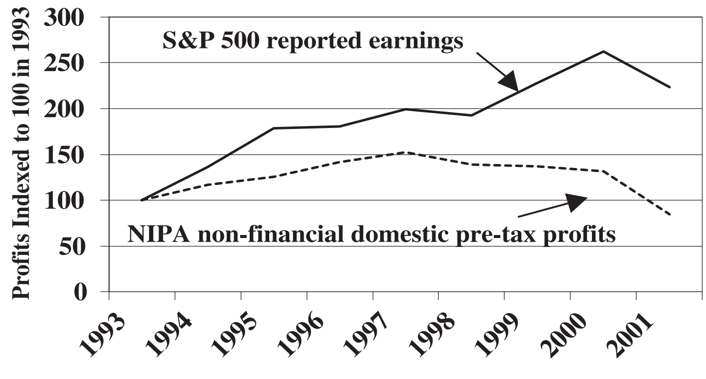
How important are profits for economic growth? Putting it briefly and bluntly, they are all-important. The expectation of reasonable profits is the indispensable condition for businesses to produce and to invest. John Maynard Keynes wrote: *"We live in a society organized in such a way that the activity of production depends on the individual business man hoping for a reasonable profit, or at least, to avoid an actual loss. The margin which he requires as his necessary incentive to produce may be a very small proportion of the total value of the*

product. But take this away from him and the whole process stops."

Or to quote the icon of American business-cycle analysis, Wesley Mitchell (1874-1948): ***"The quest for profits is the central factor controlling economic activity. Accordingly, the whole discussion must center about the prospects of profits."***

Given the paramount importance of actual profits and profits prospects for production and investment, American economists' general disregard of this ominous, dismal corporate profit performance keeps astounding us.

NIPA Profits Peaked in '97 and Are Now Below '93 Levels



Data: US DOC, NYU; Chart: Rockville Research

HIGH TECH'S CENTRAL ROLE IN BRINGING ON THE RECESSION

Considering that the sharp decline in profit margins effectively started in 1997 at the height of the high-tech boom, it has to be assumed that this precipitated the economy's slowdown, rather than the other way around. It was the looming profit malaise that ushered in last year's investment bust and recession, even though consumer spending remained unusually strong.

While the overall profits slump is ominous and shocking, even more frightening is the extreme divergence in their performance between sectors. Certainly the greatest irony of all is that the worst profit numbers by far have been coming from the one sector for which Wall Street was trumpeting unprecedented miracles of profit and productivity growth: the new high tech. That these poor profits were even heavily inflated by gains in the stock market is meanwhile common knowledge.

This sector's profits are found in the national income accounts within the item "electronic and other electric equipment." According to the latest statistics, these profits peaked in 1997 at $22.8 billion. From then on, they went steeply downward: $7.6 billion in 1998, $6.2 billion in 1999, $3.7 billion in 2000. In 2001, the sector plunged $7.2 billion into the red for the year as a whole, including negative $13.3 billion, at annual rate, in the fourth quarter.

Weighing this profits disaster in high tech, it should be considered that even at the height of the boom, in 2000, the electronic and electrical equipment sector provided barely 0.75% of total nonfinancial profits. In the GDP accounts, on the other hand, information technology accounted for one-third of the measured real growth.

This profits implosion in the high-tech sector has to be judged against the backdrop of literally exploding output. In a speech to the Washington Economic Policy Conference of the National Association for Business Economics (March 27, 2001), Mr. Greenspan boasted of the overwhelming role of the new technology in U.S. industrial production:

"In total, high-tech goods — semi-conductors, computers, and LAN equipment — currently represent less than 8 percent of total manufacturing output. However, their production, as we measure it, rose at an average annual rate of 50 percent in the second half of the 1990s, and taken together, they contributed two-thirds of the increase in manufacturing output between 1995 and 2000."

To all appearances, Mr. Greenspan regards the preponderance of business investment in information as a great boon for the economy. To us, it suggests grossly excessive investment into improved information at the expense of investment in production equipment.

In this same speech, by the way, Mr. Greenspan brags about the origin of America's excellent high-tech numbers: improvements in their measurement. To quote him again:

"Even the measurement of some goods prices presents considerable challenge. High-technology goods are a case in point. Academic research in this area dates back to the mid-1960s, but its application in the measurement of real output gained prominence with the introduction of hedonic price indexes for computers and peripherals by the Bureau of Economic Analysis in 1985… The characteristics of these goods present the range of complexities that one faces in measuring quality-adjusted prices… This so-called 'hedonic' technique, applied by the BEA, now accounts for 18 percent of GDP."

What the miserable profit numbers really say is that the new information technology grossly lacks profitability. It is a point that we have been emphasizing for years, arguing and explaining that this technology has peculiarities that make it inherently profitless.

NEW TECH AS PROFITS DESTROYER

Yet the high-tech sector clearly played an outstanding role in creating incomes and wealth in recent years in the United States. But the crucial point to realize is that this occurred completely through valuation gains in the stock market, not through income and profit creation from current output.

During the final run of the late bull market, the tech-heavy NASDAQ came to account for over a third of U.S. market capitalization — yet tech profits never surpassed 1% of total profits. As a result, this rapidly-created paper wealth vanished just as quickly once the speculative bubble burst.

For sure, the resulting fabulous wealth effects played the key role in boosting GDP growth, but it should be realized that such gains in market valuations add absolutely nothing to the economy's productive power. To the extent that the wealth effects fuel higher consumer spending, this essentially curtails investment spending, actually impoverishing the country.

Ironically, Corporate America's merger and acquisition mania has played a key role in driving stock prices to stratospheric levels, as companies typically pay vastly in excess of actual market prices. The conventional argument for this strange practice was that the big premiums regularly paid and capitalized in balance sheets represented "goodwill," reflecting big future gains in operating efficiency.

As with so many other triumphant boasts about America's new entrepreneurial efficiency, this high-riding claim, too, is proving complete nonsense. Writing off huge amounts of goodwill in their books, now running altogether into hundreds of billions of dollars, has become the new emblem of America's new entrepreneurial culture.

PRODUCTIVITY WITHOUT PROFITS

What's more, the profits debacle implicitly makes shambles of the trumpeted productivity miracle. Normally, high productivity growth and high profit growth go together. America's flagrantly opposite experience in this respect has been the great exception. Most ludicrously, the high-tech sector stands out with the biggest productivity gains and the worst profit performance.

Inherently, productivity growth increases real GDP and in its wake national income. But the obvious trouble with the greater part of the recorded U.S. productivity gains is that the normal income effects are lacking because the measured increases of real GDP accrue overwhelming from reductions of its price deflator, among them in particular the hedonic pricing of computers.

What matters for profit creation, however, is income growth, not GDP growth. GDP is an abstract macro aggregate that has no economic relevance to anybody in the economy — not private households or businesses. Such productivity growth is statistical hot air.

Years ago this consideration induced us to discard the hedonic pricing practice as economic nonsense. But observing more and more types of statistical fudge, we are increasingly wondering whether or not there is systematic delusion behind these practices. Take, for instance, the apparently stellar first-quarter GDP numbers.

A CRITICAL LOOK AT RECENT U.S. ECONOMIC DATA

Good looks in the aggregate are concealing bad looks in detail. The main sources of the economy's strength were a big swing in inventories and strong increases in government spending. Growth of private final demand has remained dismal.

As to real GDP growth, the usual distortion through hedonic pricing of computers keeps growing as quality-adjustments are accelerating. During the six months of the fourth quarter of 2001 and the first quarter of 2002, business spending on computers increased by $4.9 billion, from $78.5 billion to $83.4 billion. Hedonic pricing turned this nothingness into a major rise by $44.4 billion, from $265.7 billion to $310.1 billion.

In addition, we keep stumbling over flagrant inconsistencies in the official U.S. statistics. These people do not even bother to cross-check their stories between themselves. Month for month, the Labor Department has been pleasing the markets with two grossly conflicting numbers: steadily rising employment yet sharply falling hours worked implying record-high productivity growth.

A second peculiarity that has caught our critical attention is the regularity with which reported increases result entirely from a substantial downward revision of the prior month's number. The April employment report showed an increase of 43,000 jobs. But its true source was a sharp downward adjustment of the prior month's employment number by 79,000. In March, the reported increase of 58,000 followed a downward revision for February by 68,000. This pattern has repeated itself month after month since last October.

Focusing on new orders for capital goods as an early indicator of business investment spending, we discovered precisely the same pattern in the Commerce Department's monthly reports on new orders and shipments of durable goods. All monthly gains result from an even bigger downward revision of the number for the prior month.

On April 24, the Commerce Department disappointed the markets by reporting $173.4 billion of new orders for durable goods in the month of March. This represented a 0.6% decrease from $174.4 billion the month before. Yet it went unnoticed that this number had been given as $179.4 billion the month before. For January, the downward-revised number that served for comparison with February was $169.8 billion, as against an originally reported $176.7 billion.

In March, orders for nondefense capital goods were 18.2% below their level a year ago, after a 14.1% decrease in the prior month. As for semiconductors, the government announced that the number of large manufacturers choosing not to participate in the voluntary monthly survey has risen to such a level that the Census Bureau can no longer produce monthly estimates.

DON'T COUNT ON THE CONSUMER

Since an early recovery of business investment spending seems highly improbable, the optimistic consensus is pinning its hopes on the consumer. His lavish borrowing and spending in recent months have certainly prevented a much deeper recession. That, however, is the very reason why another boost from consumer spending is very unlikely.

During 2001, for the first time ever, consumer indebtedness grew substantially faster than income, with consumer debt rising $610 billion, compared to a $404 billion rise in income. Nevertheless, consumer spending has sharply slowed for the year as a whole to $302.6 billion, from $478.2 billion in the year before. Going forward, the consumer is plainly up against strong headwinds that make a further decline of his spending far more probable than a rise.

First, his extraordinary borrowing and spending binge throughout autumn and winter has been supported by various positive coincidences that must be regarded as transient. Among these were temporary zero-financing deals by auto manufacturers and others, as well as rising house prices in the wake of a sharp fall in mortgage rates, which fuelled a burst of mortgage refinancing. At the same time, the consumer benefited from a sharp decline in energy prices, and additional big savings on energy bills owing to the unusually warm winter.

What's more, this time there is no recession-depressed, pent-up demand. Instead, the consumer has heavily borrowed from the future. The safest thing to say, therefore, is that he will not lead the global recovery as everyone expects. For good reason, the Fed wants clearer evidence that business outlays are gathering momentum.

Another consideration is consumer confidence. Admittedly, the American consumer is far more upbeat than in past periods of economic weakness. Back in 1992, job jitters kept the Conference Board's index of consumer confidence seesawing between 50 and 80. Last April, it stood at 109.

In our view, such surveys are ballyhoo. True, in the past these and other forward-looking indicators have always accurately predicted coming recessions and recoveries. But this accuracy had its obvious reason in the fact that the regular sequence of economic downturn promptly followed by an upturn was solidly embedded in the economy's cyclical pattern of growth. Under these conditions, any other indicator, however silly, would have displayed the same accuracy.

But this time, the underlying economic conditions are diametrically different. This time, the consumer's confidence in the future is grossly misplaced. Monitoring underlying economic and financial conditions, our conclusion is that the high-riding confidence of the American consumer is in for a devastating shock.

AMERICA'S CENTRAL IMBALANCE

Looking back over the past boom years, the consumer borrowing and spending spree clearly stands out as the U.S. economy's central imbalance. Based on extremely loose credit and booming property and stock values, private consumption escalated as a share of GDP during the five boom years to 2000 by seven percentage points to 77%.

The connection of this massive change in the allocation of resources with the wealth effects of the asset bubble is obvious and undisputed. Compared with a long-term consumption ratio of 67% of GDP, this ranks, by definition, as the characteristic of a bubble economy that has run into an extreme.

Directly related with the consumer borrowing and spending bubble was, of course, the collapse of the personal savings rate from 5.6% of disposable income in 1995 and 4.2% in 1997 to virtually zero in late 2001.

We attach great importance to this finding because it flagrantly rebuts the prevailing perception that America's New Economy ascended from an unprecedented boom in capital investment. As we have been stressing for many years, this is a thoroughly false impression that was mainly due to the misleading measurement of investment in computers. Investment in money terms was no higher in the aggregate in the late 1990s than in the past.

What's more, there has been an obscene disproportion between investment in information equipment and investment in production equipment. Outside the high-tech sector, American manufacturing, actually, invested much less than it had in previous booms.

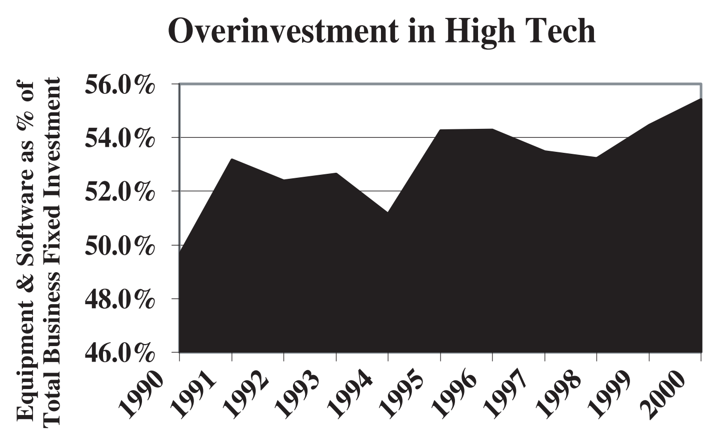
Between 1995-2000, gross investment in new technology soared by $204 billion, as against a rise of gross investment in equipment for production by a mere $38 billion. In real terms, the difference was $366.7 billion against $31.1 billion. Growth of net investment in conventional production equipment was probably negative.

On closer look, it emerges that the reality behind the highly impressive U.S. real GDP growth numbers of the past few years was a mixture of massive overconsumption and large malinvestments in the new information technology, both being funded by cuts in domestic investment for production and a widening river of foreign debt.

This statement goes a long way to identifying the culprits behind corporate America's unusually poor profits performance. Loss-making, large-scale malinvestments in new technology are among the most obvious culprits. However, the profits malaise is by no means confined to high tech. It is raging across the board.

REASONS FOR THE ABYSMAL PROFITS PERFORMANCE

We have already seen that the sharp decline in profits began four years *before* the onset of recession last year. So the recession has not brought about a decline in profits — but rather the other way around. Recently, however, another explanation has been offered to explain the dismal profits performance: a lack of pricing power. In the current climate, goes the argument, corporations are no longer able to pass on rising labor costs to their customers in the form of higher prices.



Data: Bureau of Economic Analysis; Chart: Rockville Research

In apparent support of this idea, the broadest gauge of the U.S. price level — the chain-weighted GDP price index — inched up by just 0.8% (annual rate) in the first quarter of 2002. Following a decline of 0.1% in the final quarter of 2001, this brought the two-quarter average to slightly below 0.4% — representing the slowest inflation rate since 1954.

We have three objections to this pricing power argument. *First,* the poor profit performance started in 1997. That means it covers several years when inflation rates were still on the high side, between 2–3%. *Second,* the reported magnificent productivity growth, if true, ought to have boosted profits even with low rates of inflation. *Third*, the measurement of inflation in the United States is riddled with dubious quality adjustments. Actual rates have been considerably higher.

What, then, were the main causes of the profitability slide, if not a lack of pricing power? There were three: rising depreciations, large malinvestments in profitless new high tech and the soaring trade deficit.

Depreciations on fixed capital continue to increase, of course, even when investment spending declines. The coincidence of rising depreciations and sharply falling business investment puts a double-whammy on profits because rising business investment is normally the most important macro profit source for the business sector.

The reason for this is that what businesses spend on capital investment adds to overall business revenues, but its profit-making peculiarity is that *no expenses are incurred* until the first depreciation charges set in. From the macro perspective, an increase in ***net*** investment equals a simultaneous increase in profits.

But our macroeconomic analysis of profit-relevant flows of funds identifies still another major depressant of corporate profits across the board. That's the trade deficit, which skyrocketed from $89.3 to $364 billion between 1997 and 2000. Many American economists like to discard it as the bogeyman of notorious doomsters. Yet this bogeyman happens to be the U.S. economy's single biggest profit killer.

After all, what the public earns derives directly or indirectly from salaries, wages, rent and interest that businesses have paid as costs of production. The recipients of these payments expend the greater part of their income on consumption goods from domestic producers. To this extent, former business costs return to the domestic business sector as revenue. But when the consumer buys foreign goods, this return flow of costs fails to materialize, and the domestic business sector ends up with costs that exceed receipts.

In the U.S. case, the hugely negative impact of the soaring trade deficit was, however, substantially cushioned by the consumer's massive dissaving, implying that he paid for the foreign goods with borrowed money.

KEY PROFIT SOURCES

In any case, the emphasis on inflation rates as a key profit source is badly flawed. The process of profit creation is far more complex than the divergence between sales prices and costs. Obviously, all expenses reduce profits; all revenues increase them. Profits are created to the extent that business revenues exceed business expenses. What the "pricing power" concept overlooks is that business revenues largely accrue from flows other than consumer spending.

Trying to sort out the major influences bearing on U.S. corporate profits in the foreseeable future, we regard personal saving as probably the most dangerous swing factor. Though the consensus hails the persistence of strong consumer borrowing and spending as a pleasant surprise, it is definitely unsustainable. Its recent key source has been the explosion in cash-out mortgage refinancing. Recent evidence suggests that its impact has been drawn out by delays in processing the glut of applications and that the amount erased was far larger than assumed.

Yet the mortgage-refinancing surge is not going to last since all its propellants were of temporary nature. Hence the inexorable outgrowth will be a rise in personal saving with pervasive negative effects across the whole economy. Above all, it will devastate business profits.

From the macro perspective, it is important to see that the consumer's massive dissaving — meaning that he spent more than he earned — over the past few years gave a tremendous boost to business profits. Nevertheless, these performed very poorly. Why? Because other macro profit sources turned heavily negative. These were mainly of two kinds: first, a mixture of declining net investments with large, profitless malinvestments of the high-tech sector, and second, the soaring trade deficit.

There is one institution in the United States that practices this macroeconomic profit calculation, regularly publishing their results. It is the Levy Institute in Mount Kisco, New York (*The Levy Forecast*). Their recently expressed view is that the two swing variables that will largely determine the course of profits and the economy are personal saving and capital spending. *"Profits will at best edge upward in the first half and may well slide in the second half of the current year."* We agree one hundred percent.

A DIRE OUTLOOK

Optimistic forecasts nevertheless abound, but there is no more behind them than the naïve assumption that the customary cyclical experiences of the past will essentially repeat. To quote Keynes again: *"Men like dogs are only too easily 'conditioned' and always expect that, when the bell rings, they will have the same experience as last time."* But the conditions that spurred the business cycle recoveries of the past are not present this time.

On the level of final demand, all past cyclical recoveries were primarily propelled by two demand components: residential building and business equipment. The fluctuations of the two have always been the essence of the business cycle, in America as elsewhere. The view widely held and propagated by American economists — that consumer spending typically leads the business cycle — goes flatly against all empirical

evidence. Except for housing, it has regularly tracked the growth rate of GDP.

According to a study by the Federal Reserve Bank of New York (*Quarterly Review, Summer 1993*), real GDP growth during the first eight quarters of postwar recoveries has averaged 10.2%. The increases in the major demand components averaged as follows: consumer spending 9.9%; housing 36.7%; and producer durables 21.4%.

But those spurts in housing and business spending on equipment always occurred from recession-depressed levels, implying substantial pent-up demand. This time, residential investment has not been depressed at all. It is one of the remaining great bubbles in the economy. The prospects for increased business investment, meanwhile, remain bleak as long as the profits outlook is poor.

Looking from this vantage point into the rest of the year and the further future, two questions are uppermost in our mind: one is the extent of the consumer's inevitable pullback; and the other one is the response of the U.S. financial system and the dollar to the recognition of an aborting U.S. economic recovery.

As to the consumer, his prolonged borrowing and spending binge is the one and only hope for a sustained economic recovery at which everybody is clutching. While his behavior appears vigorous, it is in reality pathological and unsustainable.

His near-zero personal savings rate certainly reflects great optimism. Yet this completely fails to impress us. What else to expect from the broad public with little knowledge in economics than that it echoes what all the experts are trumpeting. No economic downturn in the past has been accompanied by such a bombast of propaganda that tries to maintain confidence in the naïve belief that this is able to initiate economic recovery.

Careful scrutiny of underlying economic and financial conditions tells us categorically the apparently still prevailing optimism of the consumer is grossly misplaced and that very shocking economic and financial disappointment is waiting for him. Once this recognition sinks in, the consumer will retrench in his spending and stock holdings.

This will be the decisive inflection point for the U.S. economy, its financial markets and its currency. As their stock market wealth dwindles, private households will woefully return to saving from their current income — with devastating effects on business profits. A return of the personal saving rate to 5% of disposable income would spell big economic and financial trouble. But in past recessions it went to 8-10%.

THE GREAT CALAMITY WAITING TO HAPPEN

Apparently, it is time again to address a theme we have neglected for many months: the dollar and its prospects. Long ago, we predicted the dollar's collapse. But despite the soaring deficit in the current account, it went from strength to strength. This however, did not change our opinion.

What has happened with the dollar since 1995 is more or less a repeat of the experience of the first half of the 1980s. Thanks to booming financial markets and the prevailing perception of superior economic performance, the United States attracted capital inflows that easily covered the soaring deficit in its current account.

Yet we took the opposite view. Noting the exploding U.S. budget deficit, an unprecedented consumption boom and the soaring trade deficit, we kept warning of the dollar's inevitable plunge — in contradiction to the bullish consensus that believed in the U.S. economy's renaissance through supply-side Reaganomics.

The final outcome of the dollar's bull-run in the early '80s is now well known. The reversal came when the U.S. economy slowed down in 1984-85. Inexplicably, the dollar even surged at first, but soon began an even sharper decline. Yet in the summer, it seemed to start a new rise. As all major governments, except for Japan's, wanted a lower dollar, the fears of renewed appreciation galvanized the celebrated Plaza Accord of Sept. 22, 1985.

Although the following joint interventions of the central banks to weaken the dollar were on a very small scale, the U.S. currency went — with strong intermittent fluctuations — into a long, steep slide that ended in May 1995.

The single most important question at this juncture is definitely whether any decline of the dollar will be orderly and limited in scope or whether it will be as precipitous and prolonged as the fall between 1985-95. It seems the latter is unimaginable for most people. Longer-term forecasts generally project a stronger dollar next year, reflecting the U.S. economy's recovery.

It is our definite view that the U.S. currency is destined to slide to new lows, that is, below those of May 1995. Basic to this assessment is the recognition that the imbalances that have accumulated in the U.S. economy and its financial system in the wake of unprecedented credit and debt excesses during the past six or seven years vastly surpass those that accrued in the early 1980s before the dollar's ensuing collapse.

The crucial test of a country's economic development from a long-term perspective are the changes in two aggregates: investment resources (savings) and investment incentives (profits). By these two measures, the U.S. economy's growth structure has been literally devastated in the past few years. National saving, net investment and profit margins are at all-time lows. Their malignant counterparts are a record-high share of private consumption in GDP and soaring foreign indebtedness.

Pondering the dollar's vulnerability, comparisons with conditions and events in the early 1980s are certainly informative. At the time, everybody was awed by the exploding gap in the U.S. external current account. When the dollar's collapse started in 1985, it soared to a record amount of $122 billion, equaling 3% of GDP.

During the last two years, the U.S. current account deficit has run well above an annual rate of $400 billion, or about 4.5% of GDP. However, the biggest difference between the mid-1980s and the early 2000s is, by far, the international investment position of the United States.

In 1985, the international investment position of the United States went into negative territory for the first time. Foreign-owned assets in the United States of $1,061 billion compared with U.S.-owned assets abroad of $949 billion, for a net of negative $111 billion.

At year-end 2000, the market value of foreign holdings amounted to almost 10 times the amount of 1985: $9,377 billion, vs. U.S.-owned assets abroad of $7,189 billion, resulting in net foreign indebtedness of $2,187 billion. With another deficit in the current account of $417 billion and continuing increases in the current year, net foreign indebtedness is rapidly approaching $3,000 billion.

We mention these figures in particular for two reasons: *first,* because they are widely unknown; and *second,* they provide some idea of the fantastic magnitude of the forces that may come into operation once the dollar's invincibility comes into question…

THE DOLLAR'S COMING PLUNGE

There is a view that financial markets outside the United States are too small to absorb potential capital inflows from the United States. This misses the point that under a system of flexible exchange rates there are no flows of money at all from one country to another. For every dollar to be sold at a certain exchange rate there must essentially be a buyer at that rate.

In the absence of buyers, the exchange rate collapses.

Considering the astronomic size of foreign dollar holdings that have accumulated in past years, the stage is definitely set for a bandwagon against the dollar. And its trigger is just as obvious: growing disillusionment about the U.S. economy and its asset markets. Disappointment about the trumpeted U.S. economic recovery is the critical near-term event.

The strong dollar suited all countries and their policymakers. It suited the rest of the world as a boost to its exports, and it suited the United States as a boost to its financial markets. In actual fact, the huge capital inflows have become the U.S. financial markets' single most important pillar. Take this pillar away, and those markets will instantly collapse with devastating effects for the U.S. economy, turning quickly into a savage credit crunch.

The fact is that the exposure of the U.S. financial markets to foreign investors and lenders has grown to such preposterous magnitude during recent years that controlled, gradual dollar devaluation no longer appears feasible. It is a measure of the macroeconomic costs of allowing internal and external imbalances to grow to such extremes. Under these extreme circumstances, the alternative is only between a strong and a collapsing dollar.

CONCLUSIONS:

Measured in real GDP growth, this has been the U.S. economy's mildest recession in the whole postwar period. Yet it was the *worst* recession since the Great Depression of the 1930s measured in profit performance. There can be no doubt which of the two aggregates matters most: profits.

Considering the immense economic and financial imbalances that have accumulated during the past boom years in the U.S. economy, there can be no doubt they will draw the U.S. economy inexorably into a Japanese-style protracted recession.

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